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March 13, 2006

## **AGENDA ITEM 10a**

### **TO: MEMBERS OF THE INVESTMENT COMMITTEE**

**I. SUBJECT:** Senate Bill 1207 (Alarcon) –  
As Introduced

Majority Vote in Uncontested Corporate Elections

**II. PROGRAM:** Legislation

**III. RECOMMENDATION:** Support

This bill would establish that an approval by a majority of the shares represented and voting will be required to elect a director in an uncontested election of corporate directors.

### **IV. ANALYSIS:**

This bill would establish a new default standard requiring candidates for positions on the board of directors of California-based corporations be elected by a majority vote when the candidate is running in an uncontested election. An uncontested election is defined as an election in which the number of nominees does not exceed the number of vacant positions on the board of directors.

In such an election, a majority of shareowners represented and voting will be required to elect a director. If the incumbent director fails to be approved by the shareowners, then the incumbent director shall resign within 90 days and the board *may* declare vacant the office of that director. The author is amending the bill to specify that the board *shall* declare the office vacant and make it clear that the board may not reappoint the same candidate who failed to be elected by the shareowners. This proposed amendment is necessary to prevent boards from refusing to accept the resignation, thereby ignoring the election results.

This bill would not change the law for contested elections, which requires a plurality of votes to elect a director.

## **Background**

### **Current Election process of Corporate Directors**

In the United States, the substantive law relating to the election of directors of both public and private corporations is a matter governed by state corporation law. Currently, section 708 of the California Corporations Code provides that in any election of the members of the board of directors of a corporation, the candidates receiving the highest number of affirmative votes, of the shares entitled to be voted for them up to the number of directors to be elected by those shares, are elected.

The current voting process is considered a plurality voting standard. Plurality vote means that corporate directors can be elected by the vote of a single share unless they are opposed by a dissident candidate. In uncontested elections, where there is no opposition, voters may vote "for" the candidate, or choose to "withhold" their vote. In the current process, a "withhold" vote has no real impact or consequence as long as the candidate receives one "for" vote.

### **The Model Business Corporation Act**

Although each state has its own corporation law, a substantial majority of the states follow the Model Business Corporation Act (Model Act), either by adoption of the Model Act in its entirety or by adoption of important parts of it. The Model Act was originally developed by the American Bar Association (ABA) in the 1980's to encourage uniformity within the corporation laws of each US state. The Model Act is not binding law, but instead serves as a guide for other states. Since the adoption of the Model Act, most states have adopted significant portions of the Model Act for their corporate laws. The Model Act and its revisions have significantly influenced the development and uniformity of states' corporation laws throughout the United States.

The Committee on Corporate Laws of the Section of Business Law (the "Committee") of the ABA is currently considering proposed amendments to the Model Act relating to voting by shareowners for the election of directors. The amendments that the Committee is considering would, if ultimately adopted, address the issue of majority voting.

The Committee is considering the following amendments:

- a) Providing the ability for corporations to modify or eliminate the "holdover" rule, section 8.05(e), in the corporation's articles of-incorporation provisions. The "holdover" rule states: "(e) Despite the expiration of a director's term, he continues to serve until his successor is elected and qualifies or until there is a decrease in the number of directors." This amendment would allow amending the holdover rule on a company-by-company basis by amending the articles or bylaws. If a majority vote standard and an amended holdover rule was adopted by a company, then a director who did not receive a majority of the votes could only sit for 90 days.

- b) Adding section 10.22 which enables individual corporations to change their voting standards. The possible recommendation is that if a director receives a plurality of votes, but receives more against votes than for votes, then that director could only serve for a period of up to 90 days following the election. Then, the directors would have the power to fill the vacancy with any qualified individual, including the director who just received more against votes than for votes. There is no distinction made here between contested and uncontested elections.
- c) Amending section 8.07 to expressly permit adoption of resignation policies. Specifically, that a director may resign at any time by delivering a written resignation to the board of directors, its chair or secretary of the corporation. In addition, the resignation would be considered effective immediately, unless there is an effective date stated in the letter or upon the happening of an event or events.

#### State Demographics

California is ranked ninth of the top ten states ranked by percentage of companies incorporated (by market capitalization) in the Standard & Poor's (S&P) 500 with approximately 2 percent. Delaware, which is not considered a "model state," is ranked first with approximately 56 percent of the companies in the S&P 500. New York (8 percent) and New Jersey (6 percent) are a distant second and third respectively.

This bill would potentially affect 23 California-incorporated companies in the Russell 1000 Index, nine of which are also in the S&P 500 Index. Please see Attachment 1 for a complete list of affected corporations.

Delaware General Corporation Law (DGCL) provides that in all actions requiring shareowner approval, other than the election of directors, the affirmative vote of a majority of shareowners present and entitled to vote shall constitute the action of the owners. However, in the case of directors under DGCL, a plurality of the votes is all that is required.

#### Corporate Action Adopting Majority Vote Standard

On January 19, 2006, Intel announced that its board had approved bylaw amendments to allow for majority voting in board elections. Intel is a Delaware incorporated company. Under Intel's new bylaws, an incumbent nominee who receives more "against" votes than "for" votes would tender his or her resignation to the board. Resignations will be viewed by the board and either accepted or rejected, or reviewed to determine if further action should be taken. The board is required to act and publicly disclose the rationale for its actions within 90 days of the certification of the election results. Contested elections will still use a plurality standard.

Intel made the change after serving as a member of a majority vote "working group" convened last spring by the building trades' unions. The union pension funds, led

by the United Brotherhood of Carpenters and Joiners, brought together more than a dozen firms, including Time Warner, J.P. Morgan Chase, and Merrill Lynch to examine the feasibility of allowing for the election of directors by majority vote.

Pfizer changed its corporate governance principles to require that any directors who receive a majority of “withhold” votes at the company’s annual meeting must submit their resignation to the board. The board will then consider the resignation and make a recommendation.

Disney, and recently Wells Fargo, amended their corporate governance policies to provide that directors who receive a majority of “withhold” votes cast in the election will be required to submit their resignations to the nominating committees. Wells Fargo added a 90-day time frame to act on any resignation.

Circuit City, United Technologies and State Street amended their corporate governance policies to provide that directors who receive a majority of “withhold” votes from the total shares outstanding in the election will be required to submit their resignations to the nominating committee. The committee will then decide what action to take.

In all variations of the majority vote principle, the board maintains the final decision on the fate of its “elected” board of directors.

#### Council of Institutional Investors

The Council of Institutional Investors (CII) is strongly supportive of changing state corporation laws to make majority voting for directors the presumptive choice. From CII’s perspective, this issue addresses the heart of the U.S. corporate governance system. CII believes it is imperative that shareowners have a meaningful vote on the board since directors have a leading role in the governance of companies, and are the “elected” representatives of shareowners. CII does not believe that boards should ultimately have the ability to overrule the voting results and disregard majority votes cast by the owners.

CII adopted the following policy statement calling for directors to be elected by a majority of the votes cast when permissible under state law:

*When permissible under state law, companies’ charters and by-laws should provide that directors are to be elected by a majority of the votes cast. If state law requires plurality voting (or prohibits majority voting) for directors, boards should adopt policies asking that directors tender their resignations if the number of votes withheld from the candidate exceeds the votes for the candidate, and providing that such directors will not be re-nominated after expiration of their current term in the event they fail to tender such resignation.*

### **Proposed Changes**

SB 1207 would add provisions applicable only in an uncontested election of the members of the board of directors of a corporation. An uncontested election, for the purposes of this bill, is defined as an election in which the number of nominees does not exceed the number of vacant positions on the board of directors. In such an election, a majority of shareowners represented and voting will be required to elect a director. This bill will not change existing requirement for contested elections, which only requires a plurality of votes to elect a director.

If in an uncontested election an incumbent director fails to be approved by a majority of shareowners, then the incumbent director must resign within 90 days and the board *may* declare vacant the office of that director. The author, however, is amending the bill to provide that the board *shall* declare the position vacant when an incumbent fails to be approved by the shareowners and the board may not reappoint the same candidate who failed to be approved. Existing law allows, but does not require, that a new director be elected by the board of directors to fill the vacancy. In the event the board of directors does not fill the vacancy, then the shareowners may elect a director at any time, by written consent, to fill any vacancy not filled by the directors.

This bill specifically states that in uncontested elections, votes “against” or votes “withheld” shall have a legal effect. Currently, the law states that in a contested election, votes “against” or votes “withheld” shall have no legal effect.

This bill also allows a corporation to amend its bylaws to provide that uncontested elections of directors shall be conducted in the same fashion as a contested election, pending approval of the outstanding shares.

SB 1207 differs from the current trend of majority vote policy in two significant ways. First, this bill differentiates election standards dependent upon if the election is classified as “contested” or “uncontested.” Second, directors who fail to be approved by the shareowners are removed from office within 90 days. The board of directors do not then determine the fate of this board member; it is determined by the shareowner election results.

### **Legislative History**

- 2004 AB 2752 (Chu) – Would have required publicly traded companies subject to the California Corporations Code to establish corporate election procedures for election to the board of directors, and to have a copy of their corporate election procedures available to shareowners upon a written request and post the procedures on the corporation website. Vetoed by Governor Schwarzenegger. The Governor’s veto message stated this bill placed new, unnecessary filing requirements on California business. *CalPERS’ Position: Support*

- 2004 Chapter 92 (AJR 79, Chu) – Urges the Securities and Exchange Commission to implement proposed Rule 14a-11 at the earliest possible date, to address the urgent need for reform in increased shareowner access to the proxy in corporate board elections and to promote corporate board accountability and responsiveness to shareowner concerns. *CalPERS Position: Support*

## **Issues**

### **1. Arguments in Support**

*Organizations in Support: None registered to date.*

### **2. Arguments in Opposition**

*Organizations in Opposition: There is currently no known opposition.*

### **3. Board Direction**

On March 14, 2005, the Investment Committee voted to amend CalPERS' Corporate Governance Core Principles to advocate majority vote election procedures for corporate directors, and directed staff to pursue this reform through the CalPERS' Governance Program.

As a result of this amendment, the following statement has been added to the CalPERS Corporate Governance Core Principles:

Section IV. Governance Guidelines, D. Shareowner Rights:

1. *In an uncontested director election, a majority of shareowners should be required to elect a director. In a contested election, a plurality of votes should be required to elect a director.*

Additionally, under this general direction, staff is also pursuing the concept of majority vote in various capacities. Specifically,

- a. Staff is seeking to implement majority vote policies and/or bylaw and charter amendments at individual companies.
- b. Staff is seeking to implement the majority vote concept within state law where feasible.
- c. Staff is seeking to implement the majority vote concept at more macro levels, such as the Securities Exchange Commission or the major stock exchanges.
- d. Staff is supporting efforts to provide for majority vote through organizations such as the International Corporate Governance Network and the Council of Institutional Investors.

#### 4. Increased Accountability of Board of Directors to Shareowners

Majority vote enhances accountability of board of directors to their shareowners. Because the vast majority of elections for directors of public corporations are not contested, it is argued that shareowners of public corporations lack the means to object, in a meaningful way, to the directors' management policies or decisions.

The plurality system does not afford shareowners the opportunity to clearly communicate their objections to the election of candidates in an uncontested election. Furthermore, in an uncontested election using a plurality voting system, a nominee may be elected even if he or she receives very few favorable votes (or even one single vote), regardless of how many votes are withheld from that nominee.

Ultimately, majority vote makes board of directors more representative of the shareowners.

#### 5. Potential Negative Consequences of Failed Elections

The ABA has published its Preliminary Report of the Committee on Corporate Laws on Voting by Shareowners for the Election of Directors. In this report, it was argued that the potential negative consequences of failed elections, combined with the uncertainty of applying an untested voting standard as the default rule for public corporations, warrants the retention of plurality voting.

The report identifies potential consequences of a failed election in which a director does not receive a required majority vote, which include, but are not limited to the following:

- If a candidate who is the CEO or other senior executive is not elected, it could constitute a breach of that executive's employment agreement, and may trigger an obligation on the part of the corporation to make severance payments to that executive.
- The failure to elect a specified percentage of directors could result in a "change of control," thus accelerating or canceling a line of credit provided in a credit agreement, or triggering changes in licenses, franchise agreements or other important arrangements.

The failure to elect one or more candidates could adversely affect the corporation's ability to comply with listing standards or other requirements for maintaining independent directors or directors with particular qualifications.

#### 6. 90-day Holdover Period

The 90-day holdover period refers to the time allowed for a director who has failed to be elected to submit his or her resignation to the board of directors. One option for a director who fails election is the requirement to submit their resignation and depart the board immediately. This would represent true

accountability to shareowners, though this raises other issues. As discussed above, the ABA raised a concern of "failed elections" and other "holdover" issues in their preliminary review of the majority vote issue which make it "unwise" to propose a universally applicable change in the statutory plurality default rule. One issue being the adverse affect on corporations' ability to comply with listing standards or other requirements for maintaining independent directors, or directors with particular qualifications.

CII has suggested that companies be given some period of time to keep directors around to address those issues. A 90-day period has been put forward by the ABA in their preliminary recommendation which, if adopted, would allow companies to opt-out of the current (unlimited) holdover rule to a 90-day holdover rule.

CalPERS staff is on record to the ABA and Delaware State Bar Committee supporting the concept of allowing a short period of time to allow board of directors to keep directors around long enough to stay in compliance with listing standards (e.g., independence requirements or "financial expert" requirements) or to allow a Board enough time to reconstitute itself in the event a majority or all of the directors were not reelected by a majority vote.

#### 7. Legislative Policy Standards

CalPERS' Legislative Policy Standards suggest a support position for proposals which preserve established CalPERS standards and policies. The Board directed staff to implement the majority vote concept within state law where feasible. Therefore, staff recommends a support position on SB 1207 since it is consistent with the Board's Corporate Governance Policies and Core Principles.

### **V. STRATEGIC PLAN:**

This item is not a specific product of the Annual or Strategic Plans, but is a part of the regular and ongoing workload of the Office of Governmental Affairs.

### **VI. RESULTS/COSTS:**

This bill would establish that an approval by a majority of the shares represented and voting will be required to elect a director in an uncontested election of corporate directors.

#### **Program Costs**

SB 1207 does not impact CalPERS program costs.

#### **Administrative Costs**

SB 1207 does not impact CalPERS administrative costs.



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**SB 1207 – Majority Vote in Uncontested Corporate Elections**

List of California Incorporated Companies

<b>Company Name</b>	<b>Ticker</b>	<b>Index</b>	<b>S&amp;P 500</b>	<b>Market Cap</b>
Apple Computer, Inc.	AAPL	Russell 1000	Yes	\$ 60,586,587,782
bebe stores, inc.	BEBE	Russell 1000	-	\$ 1,279,624,291
Broadcom Corporation	BRCM	Russell 1000	Yes	\$ 16,232,875,790
Cisco Systems, Inc.	CSCO	Russell 1000	Yes	\$ 105,160,397,655
Copart, Inc.	CPRT	Russell 1000		\$ 2,086,585,668
DreamWorks Animation SKG, Inc.	DWA	Russell 1000		\$ 2,532,517,859
Edison International	EIX	Russell 1000	Yes	\$ 14,208,626,694
ESS Technology, Inc.	ESST	Russell 1000		\$ 136,546,081
First American Corporation (The)	FAF	Russell 1000		\$ 4,342,525,089
Mercury General Corporation	MCY	Russell 1000		\$ 3,178,806,527
Mission West Properties, Inc.	MSW	Russell 1000		\$ 179,423,374
Network Appliance, Inc.	NTAP	Russell 1000	Yes	\$ 9,648,639,000
Novellus Systems, Inc.	NVLS	Russell 1000	Yes	\$ 3,217,066,120
Pac-West Telecomm, Inc.	PACW	Russell 1000		\$ 36,027,969
PG&E Corporation	PCG	Russell 1000	Yes	\$ 13,910,882,140
Pixar Animation Studios	PIXR	Russell 1000		\$ 6,268,517,025
Public Storage, Inc.	PSA	Russell 1000	Yes	\$ 9,340,824,182
Sempra Energy	SRE	Russell 1000	Yes	\$ 11,527,884,391
Trimble Navigation Limited	TRMB	Russell 1000		\$ 1,907,658,480
UnionBanCal Corporation	UB	Russell 1000		\$ 9,935,893,157
Westcorp	WES	Russell 1000		\$ 3,482,030,956
WFS Financial Inc.	WFSI	Russell 1000		\$ 3,128,880,137
Williams-Sonoma, Inc.	WSM	Russell 1000		\$ 4,980,398,329

As of February 10, 2006